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ATTEMPTING THE IMPOSSIBLE WHILE IGNORING THE FUNDAMENTAL IN RURAL FINANCIAL MARKETS

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Many policy makers believe that rural financial markets (RFMs) can be used to alter farmer behavior and allocate subsidies to the poor through loan targeting and concessionary interest rates. In the following I argue that this is impossible, and that imposing these tasks on RFMs subverts the fundamental contribution these markets make to development.

ROLE OF FINANCE IN RESOURCE ALLOCATION

The most important role of RFMs in development is facilitating the transfer of claims on resources, and ultimately resources, from surplus to deficit units. This, in turn, accelerates specialization and allows producers to increase trade and flex comparative advantage. A simple two-firm example may illustrate this point.

Assume that firms "A" and "B" are too distant from each other to make contact through barter or through an informal intermediary. Further assume that "A" has too little liquidity to capitalize on high marginal returns to productive investments, while "B" has excess liquidity and expects low marginal rates of return on all intra-firm investments. Without financial intermediation, "A" is forced to under-produce for want of additional claims on resources, while "B" must consume surplus goods or invest them in activities that yield few returns. Access to an efficient financial system allows "B" to avoid low return consumption or investment endeavors through making deposits with an intermediary. If, in turn, the intermediary grants a loan to "A" out of the deposits, "A" can use these claims on resources to purchase inputs that increase output.

Fragmented financial markets do not provide these connections. If financial markets are repressed, or are shallow and connect only a few firms or households, the aggregate losses can be substantial when millions of units are involved.

LIMITATIONS OF RFMS AS FISCAL AGENTS

Virtually all countries use financial markets to help the poor. The Farmers' Home Administration, student loans, and the Small Business Administration are examples. In many countries cheap loans are the principal government program for the rural poor.

There are three ways in which a loan may help a borrower: through the income transfer embodied in the concessionary interest rate, through an income transfer realized by borrowers who steal the loan, and through the increased net income produced by resources bought with borrowed funds. RFMs, however, are ill suited, for at least three reasons, to be fiscal agents for the poor. First, any income transfer tied to a loan is always proportional to the size of the loan: large loan, large subsidy; small loan, small subsidy; and no loan, no subsidy. Since the size of loan is highly correlated with income and assets, loans are a regressive vehicle for redistributing income. Second, these problems are not resolved by charging lower interest rates on small than on large loans, or by being permissive on loan defaults among borrowers of small amounts, while taking a hard line on loan recovery from borrowers of large amounts. It is unrealistic to believe that those with economic power will long tolerate income transfers in which they do not participate. Also, this strategy presents a perverse set of incentives to financial intermediaries. On the one hand, policy makers tell the intermediary that lending to the poor has high priority. On the other hand, to effect the income transfer policies are set so that the intermediary is forced to charge the lowest interest rates and absorb the most defaults on those loans that are most costly to service per unit of money lent. This is asking the lender to commit financial suicide, regardless of who owns the institution. Lenders who fail to cover their costs of lending, capital erosion due to inflation, and loan losses with interest receipts become mendicant at the public or donor trough, or perish.

The intermediary's desire to sustain the institution by reducing costs coincide with the interests of the economically powerful to capture income transfers. These forces collude to concentrate cheap loans in the hands of the relatively well-to-do in most countries under all political systems. There are too many dispersed participants in rural financial markets and too many transactions for any central authority to force insiders to do something against their interests.

Deposit disincentives are a third argument against using RFMs as fiscal agents. If interest rates are low on loans, intermediaries must pay lower rates on deposits. The subsidy for the fortunate borrower is paid for by a "tax" on individuals who hold deposit accounts that receive a repressed interest rate, or by those who would deposit money if the rates were higher. The rural poor are affected more by these taxes on deposits than are the well-to-do because they have fewer savings alternatives.

Using RFMs as fiscal agents to differentially help the poor has effects similar to using a strong laxative to treat a broken leg. Not only does the treatment not relieve the problem, but it also has important adverse side effects. In most cases, the well-to-do end up with the bulk of the benefits transmitted through credit, and the poor are denied, not only access to cheap credit, but also access to attractive deposits.

LIMITATIONS OF TARGETED LOANS

It is also common for governments and donors to target loans at enterprises, at inputs, and at investments. These loans usually carry inducements such as low interest rates and grace periods. The two key assumptions behind loan targeting are that individuals can be induced to do what they would otherwise not do, or do too slowly, through the offer of concessionary loans. And, that most targeted individuals are too liquidity-short to make a desirable investment, without a loan.

Concessionary rediscount lines in central banks are the tracks of targeted programs. In some large countries there may be hundreds of these lines. Even in small countries it is common for the central bank to offer dozens of discount lines. Each is aimed at a target group, area, or activity, and each carries its own reporting requirements and lending terms. The hoped-for results of these loans stem from two effects: interest-rates and loan-volume. For example, it is hoped that low interest rates on fertilizer loans will induce borrowers to use more fertilizer. Or, that concessionary interest rates on rice loans will induce borrowers to produce more rice. The key assumption here is that the price of the loan directly affects the relative profitability of a targeted input, enterprise, or investment.

A critique of the interest-rate-effect argument requires understanding sources and uses of liquidity by rural firms. It is typical for them to have multiple enterprises and sources of income. These enterprises, and the inputs used, have a relatively high degree of substitutability. Most farmers decide on their mix of enterprises and the proportions of inputs used based on product and input prices, plus the contribution of inputs to production. Likewise, most farmers have multiple sources of liquidity. Since there is a high degree of fungibility among these sources and uses, there is no reason to expect a causal relationship between the costs of acquiring access to one source of liquidity, and changes in the relative profitability of any input used or product produced. If fertilizer use, in the opinion of the farm operator, did not pay before obtaining a cheap loan, it still does not pay to use fertilizer after obtaining the loan.

Raising the price of the targeted product, lowering the price of the targeted input, or enhancing the productive capabilities of inputs are incentives that motivate farmers. While cheap credit, combined with high rice prices, will cause farmers to produce more rice, realistically priced loans combined with high rice prices will give the same result, but with less government expense. The price placed on a loan has no direct relationship to the relative returns from various enterprises or input uses, and, thus, interest rates on loans cannot be used to alter the way farmers make decisions about production and investment.

The effect of an increase in loan volume on targeted activities is less straight forward. The main assumption behind many credit programs is that borrowers need loans to capitalize on targeted opportunities. Further, that the targeted activity has the highest expected return among all those returns faced by the borrower. Thus, if the loan spigot is opened, the borrower has the appropriate incentive to channel the borrowed liquidity to the activity targeted. Policy makers are often so confident of these assumptions that they decree formula loans to fill farmers' "credit needs."

How much simpler the life of development doctors would be if these assumptions mirrored reality. Tremendous diversity, rather than simple stereotypes, however, typify rural firms and households. One farmer may expect a high marginal rate of return from the targeted activity, but expect even higher rates from other investments. At the same time, his neighbor may be flush with liquidity, face low marginal rates of return from all potential investments, including the targeted activity, and thus, place priority on using any additional liquidity for consumption. The fungibility of financial instruments and the possibility for borrowers to exercise financial substitution, make it very difficult to isolate cause and effect between loans and targeted activities.

Lending will be positively correlated with increases in targeted activities only if loans go to individuals who can realize high rates of return on targeted endeavors. Because of the thousands of heterogeneous borrowers involved, it is impossible for a policy maker in a distant capital to pre-program how much and who should get these loans. Ultimately, the intermediaries must make these decision.

In sum, the volume effect of loans on the expansion of targeted activities is tied to two other factors: (1) the relative rates of return borrowers expect from these activities--rates that are determined independent of the ebbs and flows in the supply of credit. And, (2) how efficiently the lender rations loans to those who have the highest rates of return, a topic to which I now turn.

CONFLICTS BETWEEN TARTETING AND INTERMEDIATION

Targeting affects lenders in unanticipated ways; it forces them to allocate loan subsidies regressively, imposes more transactions costs on them, and distorts their innovations. Even worse, targeting causes the financial system to be less effective in carrying out its normal function of reallocating resources among surplus and deficit units.

Providing rural financial services is expensive, as evidenced by the unwillingness of many intermediaries to do it. Small transactions, transportation costs, and uncertainties in farming nurture these costs. Loan targeting further increases these costs through adding lines of credit and reporting, as well as distorting the information flowing through financial systems. This happens at the expense of loan recovery, controlling costs, and discovering cost-reducing technologies. Often, for example, the intermediary has up-to-date information on the amount of fertilizer supposedly purchased with one of its lines of credit, but is unable to determine the recovery status of these loans or the intermediary's cost of making them. These additional costs reduce the coverage of financial markets, chew up resources that might be better used elsewhere, and shackle managers with data that are of little use to them.

When interest rates are controlled, which is common with targeting, lenders are forced to shift their transactions costs and increase collateral requirements to ration loans. This results in additional hurdles being placed in the way of non-preferred borrowers: those wanting small loans, first-time borrowers, and those with limited collateral. Non-preferred borrowers' effective costs for loans are substantially increased above levels they would otherwise pay if market rates of interest were in force. At the same time, preferred individuals who have borrowed previously from the intermediary, those requesting large loans, and those with extensive collateral may find their loan transactions costs are reduced--their effective costs of borrowing are likely to be substantially lower than if market rates of interest were charged. This of course means that some individuals get more claims on additional resources than is justified by their returns to possible investment within their firm, and that resources are inefficiently allocated among borrowers and potential borrowers.

Targeting causes similar inefficiencies among surplus units. Since rediscount lines often carry concessionary terms, it is cheaper for intermediaries to use targeted funds than to mobilize deposits. Many rural financial intermediaries have little interest in offering deposit services because of these strong disincentives. This results in large numbers of rural units being denied access to deposits they might otherwise use. Surplus firms and households are, as a result, forced to hold excesses in forms that provide low returns or to consume them. In either case, resources are less efficiently allocated than they would be if financial markets offered attractive deposit alternatives to rural units. In extreme cases, extensive loan targeting at highly concessionary terms, through rediscount lines, destroys the willingness of the financial system to intermediate among surplus and deficit units.

Extensive use of banks and cooperatives as fiscal agents, as retail outlets for central banks, and as targeteers also undermines professionalism and warps the orientation of the institution. Loan officers who mainly handle formula, targeted, and politically-conceived loans do not exercise skills necessary to lend on the basis of creditworthiness. Also, it is difficult for employees to resist tapping, through bribes, income transfers that pass through their hands. Extensive use of rediscount lines, moreover, forms a patronal financial system that sustains itself by transferring favors granted by government or donors to borrowers. The reference group for managers become the patron above, rather than the borrowers and potential depositors below. The former are cultivated, fawned over, and flattered, while many members of the latter group are treated with contempt inflicted on mendicants. Political intrusions into intermediation, plus feasts-and-famines in flows of funds through the system, result in overstaffing, serious loan recovery problems, and low quality financial services.

CONCLUSIONS

It is understandable why policy makers often opt for concessionary and targeted loans in responding to rural problems: credit programs are easy to start, can be put together quickly, transfer subsidies that are hidden, and cause mainly latent problems. There would be nothing seriously wrong with this if these efforts were somewhat successful and had few bad side effects. Unfortunately, loan targeting does little to alter borrower behavior in ways desired by policy makers, and subsidies transferred through financial markets gravitate to the non-poor. Trying the easy, but impossible, through targeting and using RFMs as fiscal agents, seriously damages the fundamental ability of RFMs to intermediate. Development efforts would be both more equitable and efficient if these practices were discontinued.